THE HONORABLE MARSHA PECHMAN

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

COSTCO WHOLESALE CORPORATION, a Washington corporation,

Plaintiff,

vs.

ROGER HOEN, VERA ING, AND MERRITT LONG, in their official capacities as members of the Washington State Liquor Control Board;

Defendants,

and

WASHINGTON BEER AND WINE WHOLESALERS ASSOCIATION, a Washington non-profit corporation,

Intervenor Defendant.

NO. CV04-0360P

TRIAL BRIEF OF DEFENDANTS AND DEFENDANT-INTERVENOR

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TABLE OF CONTENTS

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Defendants Hoen, Ing, and Long (collectively the "Liquor Control Board" or "LCB") and Intervenor Defendant Washington Beer and Wine Wholesalers Association ("WBWWA") (LCB and WBWWA are collectively referred to herein as "defendants) respectfully submit this trial brief.

I. INTRODUCTION

Alcohol is different.

This statement, though simple, is not simplistic. Alcohol is the only commodity in the history of our nation to have been the subject of not one but two constitutional amendments. Alcoholic beverages are among the most heavily-regulated products available in the market. That is because both the government and the people recognize that alcoholic beverages can have horrific effects on individuals and on society.

Recognizing the unique nature of alcohol and the high probability that different states would wish to regulate it in different ways, the 21st Amendment expressly left to the states the power to devise systems for the regulation of alcoholic beverages. That power remains intact today. So long as a State's regulatory system relates to the core purposes of the 21st Amendment and has the effect of furthering the State's interests in a manner that outweighs any federal interest in competition, the 21st Amendment will immunize the system from attack by plaintiffs like Costco.

As a "big-box" retailer, Costco uses its size to extract concessions from suppliers and distributors of products, allowing it to obtain a competitive advantage over other retailers by offering lower prices to its customers and selling greater quantities of the limited number of products it carries. Costco's ability to extract concessions is a key component of its business

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model and success. The elements of Washington's three-tier system keep Costco from taking full advantage of its business model in buying and selling beer and wine. As a result, it asks the Court to substitute Costco's vision of appropriate regulation for that of the legislature and effectively deregulate commerce in these alcoholic beverages, notwithstanding the State's constitutional right to regulate as it has chosen to do.

The evidence at trial will establish that Washington's regulatory system, considered in whole or in part, is a valid exercise of state control under the 21st Amendment. The three-tier system directly furthers the State's core 21st Amendment concerns of temperance, revenue generation, and ensuring orderly market conditions. The system and its constituent parts balance reasonable access to beer and wine at reasonable prices with control over their availability and use. Moreover, the State's 21st Amendment interests, as embodied in the challenged regulatory system, not only outweigh the federal interest in competition but also directly further other important federal interests.

The United States Constitution expressly delegates to the State of Washington the authority and discretion to engage in the delicate balancing required of any system regulating alcoholic beverages. Where the Constitution has so plainly spoken the Court should decline to act as a super-legislature. The State's three-tier system is a balanced approach to regulating the distribution and sale of beer and wine, and it is protected by the 21st Amendment.

II. THE CHALLENGED STATUTES AND REGULATIONS

As with the claims the Court has already decided on summary judgment, the starting point for any review of the 21st Amendment issue is the State's three-tier system itself, which is embodied in the challenged controls. While each of the controls works independently,

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when the system is examined as a whole it becomes apparent that the individual elements of the price-posting system, the various tied-house prohibitions and the bans on central warehousing and retailer-to-retailer sales work together to create a comprehensive system of control. Costco is intent on destroying that system.

A. The Uniform Price Rule.

RCW 66.28.180(3)(b) requires each brewery and winery doing business in the state to sell its products at uniform prices to all distributors with whom it deals. In turn, RCW 66.28.180(2)(c) requires each distributor to sell its products at uniform prices to all retailers with whom the distributor deals. The statute illuminates the reason for this requirement:

> This section is enacted, pursuant to the authority of this state under the twenty-first amendment to the United States Constitution, to promote the public's interest in fostering the orderly and responsible distribution of malt beverages and wine towards effective control of consumption; to promote the fair and efficient three-tier system of distribution of such beverages; and to confirm existing board rules as the clear expression of state policy to regulate the manner of selling and pricing of wine and malt beverages by licensed suppliers and distributors.

RCW 66.28.180(1). The Legislature adopted the uniform price rule to further "the orderly and responsible distribution" of beer and wine and to prohibit all forms of discriminatory pricing. Uniform pricing helps to assure reasonable, state-wide access to beer and wine and minimizes the temptation some retailers might otherwise feel to respond to drastic price competition by engaging in illicit purchases and sales outside the regulatory system.

B. The Delivered Pricing Rule.

RCW 66.28.180(2)(h)(ii) and WAC 314-20-100 and 314-24-190 allow distributors to deliver product to retailers at either the distributors' or the retailers' licensed premises, but require the retailer to pay the same price in either case. The distributor and the retailer may

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select whichever of the two delivery points they prefer, but they cannot modify the price based on the point chosen and cannot make or take delivery at any other location. This protects the uniform pricing goal by eliminating any advantage to those retailers capable of assuming the cost of obtaining the product directly rather than taking delivery.

C. The Ban on Quantity Discounts.

RCW 66.28.180(2)(d) and (3)(b) prohibit distributors and suppliers from offering quantity discounts on sales of beer or wine. This prohibition reinforces the uniform price rule and the ban on credit sales, furthering the State's 21st Amendment interests in temperance and orderly marketing.

D. The Ban on Credit Sales.

RWC 66.28.010 combats the evil of "tied houses," or vertical integration, by making it impossible for suppliers or distributors to tie themselves too closely to retailers. This in turn makes it less likely that a retailer will have an incentive to excessively promote or sell beer or wine in order to maintain a preferential financial relationship with a supplier or distributor. The law prohibits suppliers and distributors from having any direct or indirect financial interest in any licensed retail business, and outlaws credit by expressly barring suppliers and distributors from advancing and retailers from accepting "moneys or moneys' worth." The statutes are implemented by WAC 314-12-140(3), 314-13-015, and 314-20-090. The regulations prohibit discounts, rebates or any other extension of credit to retailers, requiring them to pay cash at or before delivery. The ban also eliminates a vehicle by which larger, more affluent retailers could gain a significant advantage over others, which would result in a destabilization of the market.

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In addition, the Federal Alcohol Administration Act contains, among other things, the federal version of a "tied house" law. *See* 27 U.S.C. §205(b). While different from, and in some respects less restrictive than, Washington's tied house laws, it nevertheless reflects a federal policy generally consistent with that of Washington.

E. The Minimum Markup Requirement.

RCW 66.28.180(2)(d) and (3)(b) bar distributors and suppliers, respectively, from pricing their products less than 10% above acquisition or production costs, setting a floor on price and making it illegal for anyone to sell beer or wine at extremely low prices just to move product.[1]

F. The "Post and Hold" Provisions.

RCW 66.28.180 requires beer and wine suppliers and distributors to post prices, independently and without public disclosure, with the Liquor Control Board. The prices posted, except those for discontinued products, must comport with the minimum mark-up requirements noted above. The system does not permit posting of anything other than uniform, delivered prices and does not permit posting of quantity discounts. The posting system prevents any retailer from receiving favorable treatment, and makes enforcement of the uniform price rule and the bans on credit and volume discounts more effective. Postings accepted by the LCB become effective on the first day of a month and must remain in effect at least 30 days. Postings are deemed investigative information and are not subject to public disclosure prior to their effective date.

[1] Similarly, WAC 314-11-085 and WAC 315-52-114 bar retailers from selling beer or wine for less than the price at which the retailer acquired it, which prevents the use of beer or wine as a "loss leader."

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The thirty-day hold makes enforcement of the uniform pricing requirement and the ban on volume discounts easier and more effective. It assures all retailers the opportunity to purchase at the posted prices. It also serves to reduce volatility in the market, which is a significant aspect of orderly marketing.

G. The Retailer-to-Retailer Sales Ban.

Washington's three-tier system requires retailers to buy beer and wine only from licensed wholesalers (or from wineries or breweries acting as and subject to all the requirements applicable to distributors) or the LCB. It prohibits retailers from selling beer and wine directly to other retailers. *See* RCW 66.28.070; WAC 314-13-010. The ban facilitates orderly marketing by making it easier to track where and by whom beer and wine are sold to retailers. It also makes it easier to enforce the ban on sales below cost.

H. The Central Warehousing Ban.

Finally, the State's central warehousing ban prohibits a retailer from receiving or storing beer or wine at its own warehouse. A retailer must take delivery at the specific licensed location from which the product will be sold to consumers. Similarly, if the retailer picks the product up from the distributor the product must be taken directly to the specific licensed location from which it will be sold. *See* RCW 66.24.185(4).[2] Again, this facilitates orderly marketing by making it easier to track sales to consumers. It also avoids the market disruptions that would occur if retailers were able to deal only with select distributors.

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[2] A wine producer may, in certain circumstances, warehouse product at a licensed, bonded warehouse location other than the winery. Up to 2,000 cases per year of wine can leave that warehouse and go directly to a retailer, without passing through a distributor. Other than in the circumstances noted above, the bonded wine warehouse statute reiterates the general ban on warehousing of product by anyone other than a distributor. RCW 66.28.180(2)(h)(ii); WAC 314-24-220 (5). Costco continues to assert that the limitations on removal of product from a bonded warehouse are among the controls it challenges, despite the fact that it did not identify the wine warehouse statute and regulation in its complaint.

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III. LEGAL AUTHORITY

A. The 21st Amendment Standard And How It Applies In This Case.

The question the Court must answer in this trial is whether Washington's 70-year old three-tier system regulating beer and wine distribution is a valid exercise of the powers granted to the State by the 21st Amendment. Costco and the defendants disagree over the proper standard the Court should apply when assessing the 21st Amendment defense. Costco's proposed standard should be rejected, as it contains elements never before applied by courts considering the 21st Amendment. To assist the Court in applying the proper standard a brief summary of the history of liquor regulation, including history specific to Washington, and of 21st Amendment jurisprudence is set out here.

1. Liquor regulation prior to Prohibition.

Until Prohibition, intoxicating liquor was regulated at the local level, even as public tolerance and the degree of regulatory control vacillated between viewing alcohol as a mere article of commerce and viewing it as a dangerous intoxicating beverage. The nineteenth century saw several waves of temperance activity with both social and political components. This activity led to greater regulation of intoxicating liquors. At different times and in different parts of the country the manufacture and sale of intoxicating liquor was banned, public dispensaries were established, and sales outlets were licensed, restricted and carefully regulated.

The evolution of our commercial infrastructure has at times undermined state and local efforts to regulate intoxicating liquor: for instance, improvements in transportation, in particular the growth of railroads, and the concomitant expansive development of the dormant Commerce Clause doctrine. As an example, the Supreme Court in *Bowman* and *Leisy*

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narrowly circumscribed the power of states to regulate the importation of intoxicating liquors. *See Bowman v. Chicago & NW Railway Co.*, 125 U.S. 465 (1888) (strikes a state law which restricted the importation of intoxicating liquor to those possessing a permit); *Leisy v. Hardin*, 135 U.S. 100 (1890) (intoxicating liquor shipped into the state remained an article of "interstate commerce," immune from state regulation, as long as it remained in its original package).

These decisions provoked Congress to pass the Wilson Act, 27 U.S.C. § 121 (1890), declaring that, upon arrival in the state, the sale, distribution and transportation of intoxicating liquor was subject to state regulation. In *Rhodes v. Iowa*, 170 U.S. 412 (1898), however, the Supreme Court narrowly construed the Wilson Act, concluding that the dormant Commerce Clause prohibited state regulation of direct shipments to in-state consumers by out-of-state distributors. As a result, railway express agencies began to function as retail outlets. Congress responded with passage of the Webb-Kenyon Act, 29 U.S.C. § 122 (1913), which gave the states power to prohibit the sale, distribution, transportation or importation of intoxicating liquor into the state in violation of its laws.[3] There could not have been a clearer expression by Congress of its intent to ensure that control of intoxicating liquor would remain with the states.

2. Passage of the 21st Amendment.

In a failed effort to impose a national solution, the Eighteenth Amendment, establishing Prohibition, was passed in 1919. That "noble experiment" lasted just fourteen years. The 21st Amendment, enacted in 1933, marked the abandonment of the effort to have a

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national policy prohibiting manufacture and sale of alcoholic beverages. From then on state, not national, regulation was to be the primary control over intoxicating liquors. The failure of Prohibition illustrated that noble motives alone, without broad support in public opinion, were insufficient to compel temperance. In fact, the draconian nature of Prohibition was counter-productive, because it led to illicit production and sale of alcohol, which in turn fostered excessive consumption, and because it seriously eroded belief in the rule of law. After Prohibition, regulation of intoxicating liquor was to be undertaken at the level of government at which it was able to obtain broad support.

The ratification of the 21st Amendment represented a constitutional commitment to make permanent the policy behind the Webb-Kenyon Act: that the state be the focus of intoxicating liquor control. Section 2 of the 21st Amendment "effectively constitutionalizes most state prohibitions regulating importation, transportation, and distribution of alcoholic beverages from the stream of interstate commerce into the state." *Craig v. Boren*, 429 U.S. 190, 205-206 (1976). Expressed another way, Section 2 grants "the States virtually complete control over whether to permit importation or sale of liquor and how to structure the liquor distribution system." *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.* 445 U.S. 97, 110 (1980).

As originally proposed, Section 3 of the 21st Amendment would have given Congress concurrent power to regulate sales. That section was eliminated. At the time, Senators Blaine

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[3] In vetoing the Bill, President Taft described it as permitting "the states to exercise their old authority, before they became states, to interfere with commerce between them and their neighbors." The veto was swiftly overridden. *See* 49 Cong. Rec. 4292.

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and Wagner explained that Section 3 would have been inconsistent with Section 2. As a result, states, not the federal government, were to enact and administer liquor regulation.

Prior to its consideration by the House, Congressman Lea objected to Section 2 because it would protect "unwise" or "improvident" state liquor laws. 76 Cong. Rec. 2776 (House)(1933). In submitting Section 2 to state conventions, Congress believed that the goal of ensuring effective state regulation outweighed any risk that states might enact laws some would deem unwise or imprudent. The 21st Amendment was intended to ensure that each state was endowed with the power to regulate alcohol in accordance with "local sentiment and local habits" *see, e.g.* 76 Cong. Rec. 4146 (1933), and to restore to the states "absolute control in effect over interstate commerce affecting intoxicating liquors which enter the confines of the states", *see, e.g.,* Comments of Senator Blaine, 76 Cong. Rec. 4143 (1933).[4]

After Repeal, the country was intent on avoiding the excessive regulation of Prohibition without returning to the inadequate regulations that preceded it. Washington and other states sought "true temperance," meaning sustainable moderation, and effective control, meaning control that could be enforced. Raymond B. Fosdick & Albert L. Scott, *Toward Liquor Control*, at 7 (1933). Policy makers struggled to reconcile the tension caused by two contrasting concepts: one of alcoholic beverages as a legitimate commodity, manufactured and sold by willing producers; the other of alcoholic beverages as a dangerous intoxicating

[4] The Senate twice was presented with language limiting Section 2 of the proposed 21st Amendment to the protection of "dry" states. The proposal twice was rejected. The first version, of what became the 21st Amendment, was proposed in December, 1932, and contained a clause protecting states that prohibited the manufacture and sale of intoxicating liquor. The Senate Judiciary Committee, in its report, changed the language to that which was ultimately enacted as Section 2. The full Senate had an opportunity to reconsider the expanded scope of paragraph 2 when Senator Glass proposed that the amendment be limited to states prohibiting manufacture and sale of intoxicating liquors, with the Commerce Clause continuing to constrain alcoholic beverage legislation in states permitting such manufacture and sale. The Glass amendment was rejected.

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beverage, capable of being abused. To resolve that tension alcohol was to be available, but rigidly licensed.

Washington adopted its own liquor law in 1933. Chap. 62, Laws of the Extraordinary Session, 1933 (Tx. 401). The Washington State Liquor Act, also known as the Steele Act, established the Washington State Liquor Control Board and set up an intricate and comprehensive regulatory system. It placed control over spirits (and "strong beer" greater than 4% alcohol) exclusively with the State; those products were sold only in state stores. The statute also set up a three-tier system for the sale and distribution of beer, where control was to be achieved by the separate licensing and close monitoring of the brewer, wholesaler and retailer tiers. Initially wine was sold exclusively though the State, but within a few years the LCB began to move in the direction of distributing domestic (Washington state) wine in essentially the same manner as beer.

The legislature recognized its task of balancing availability with control. Even as it noted in the preamble that the Act related "to intoxicating liquors, providing for the control and regulation thereof," it set up a licensing system making beer more widely available than spirits. Licensed breweries could sell to licensed wholesalers, who in turn could sell to licensed retailers. Retail licenses could be granted to various types of businesses (hotels, clubs taverns, drug stores or soda fountains) for on-premise sales or to stores other than state liquor stores for off-premises consumption. However, Section 90 of the Act stated that "no manufacturer or wholesaler" . . . could "have any financial interest direct, or indirect" in any retail licensee. Manufacturers were also precluded from advancing money to retailers. Tx.

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401-026. A year later the legislature amended Section 90 to clarify that wholesalers were similarly precluded from advancing "money" or "money's worth" to retailers. Tx. 413-021.

The LCB promptly enhanced the statutory controls of the three-tier system of separate licenses for manufacturers, distributors and retailers and of the tied-house prohibitions with a set of rules and regulations further governing the relationships between the tiers. In rules for retailers effective in November of 1934, the LCB prohibited retailers from accepting any "gifts, loans of money, premiums, rebates, free beer, property of any value whatsoever or services of any nature" from a manufacturer or wholesaler. Tx. 407-004. Similar rules for wholesalers and brewers prohibited those entities from giving anything of value to a retailer. Tx. 408-002. A year later the LCB specifically required retailers to pay cash for beer, and ordered any retail licensees who were indebted to brewers or wholesalers to retire the debt. Tx. 415-003.

From the beginning the LCB recognized the importance of requiring uniform prices to be posted in advance and held for a particular period of time. In its first amended set of regulations effective in 1935, the LCB required brewers and wholesalers to post with the LCB a "price list which shall be uniform for the same class of trade buyers in any trade area within the state." The posted prices needed to be held for ten days. Tx. 411-001. But the posting requirement pre-dated the rule. When the Act was passed the NRA code was in effect, under which brewers and beer wholesalers were required to post uniform sales prices. When the NRA code went out of effect, "it became necessary for the LCB to require that this information be filed with it in order to effectively enforce the provisions of the liquor act." Tx. 412-009.

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Significantly, the LCB's price posting rule deemed any licensee who sold at other than the posted price to have violated "Section 90 of Chapter 62 of the laws of the Extraordinary Session of 1933 as amended". Tx. 411-001. Section 90 as amended is the tied house prohibition against financial interest between manufacturer, wholesaler and retailer. Thus, even while implementing a law intended to provide people with access to beer at the local drug store, soda fountain, tavern and corner store, the legislature and the LCB were mindful of the ongoing need for control over the relationships between the tiers. The LCB announced in its Second Report covering the period from January to September of 1935 that uniform pricing, price posting and bans on credit extensions and rebates were necessary precisely to prevent "free beer" to retail licensees and to check brewers' and wholesalers' desire to "permit retailers to incur large credits and then forced them to handle their products exclusively." Tx. 412-009.

Then Governor Clarence D. Martin also recognized the tension between availability and control in his message appointing the first Liquor Control Board members. While charging the LCB with the task of implementing a statutory system that, in contrast to the immediately preceding period of prohibition, allowed access to beer, wine and spirits, the Governor recognized the balanced mission of the agency:

> It is not the purpose of this law to encourage anything other than temperance. Unlike many other businesses, you are not expected to promote sales. Instead of promoting the sale of liquor, you want to discourage the sale and use of liquor. Your function is only to make good liquor available to the people under proper conditions.

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The counter-intuitive notion that the purpose of a statutory system intended to facilitate access to alcoholic beverages was "to encourage the promotion of temperance" reflects the necessity for balance between access and control which continues to this day. Tx. 401 – 002-003.

3. Judicial interpretation of the 21st Amendment.

Alcoholic beverages have long been the subject of judicial scrutiny. Costco's novel 21st Amendment theories notwithstanding, United States Supreme Court cases over the past 40 years reveal a uniform 21st Amendment test. As the Supreme Court has consistently recognized, the Amendment did not "repeal" the Commerce Clause. *See Hostetter v. Idlewild Bon Voyage Liquor Corp.*, 377 U.S. 324, 331-32 (1964); *Joseph E. Seagram & Sons, Inc. v. Hostetter*, 394 U.S. 35, 42 (1966); *Midcal, supra*, 445 U.S. at 109 (1980); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 275 (1984); *Brown-Forman Distillers Corp. v. New York State Liquor Authority*, 476 U.S. 573, 584-85 (1986). Instead, a court considering a 21st Amendment defense must engage in a "pragmatic effort to harmonize state and federal powers." *Midcal*, 445 U.S. at 109. The Court has on several occasions explained that this "pragmatic effort" must take the form of an inquiry into

> whether the interests implicated by a state regulation are so closely related to the powers reserved by the Twenty-first Amendment that the regulation may prevail, notwithstanding that its requirements directly conflict with express federal policies.

Capital Cities Cable, Inc. v. Crisp, 467 U.S. 691, 714 (1984); *see also Bacchus*, 468 U.S. 263 (1984). Or, put a slightly different way, "[t]he question...is thus whether the principles underlying the Twenty-first Amendment are sufficiently implicated by [the challenged statute or regulation] to outweigh the Commerce Clause principles that would otherwise be offended." *Bacchus*, 468 U.S. at 275.

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To answer the "close relation" or "sufficient implication" question, a court must begin by examining the purposes and policies underlying the challenged statute or regulation. Over the years, the Supreme Court has recognized a number of purposes or policies that implicate the "core concerns" of the 21st Amendment:

- promoting temperance; *see Midcal*, 445 U.S. at 112-13, *Capital Cities Cable,* 467 U.S. at 715, *324 Liquor,* 479 U.S. at 351, *North Dakota,* 495 U.S. at 432;
- generating tax revenue; *see North Dakota,* 495 U.S. at 432; and
- ensuring orderly market conditions; *see Midcal*, 445 U.S. at 112-13, *North Dakota,* 495 U.S. at 432, *324 Liquor*, 479 U.S. at 349.

Once the Court identifies the policies underlying the challenged statute or regulation, it must then review the evidence in the record to determine whether the requisite "close relation" or "sufficient implication" exists. If the record evidence is sufficient to establish that relationship, and if the evidence shows the statute or regulation tends to further the State's interest and is not outweighed by the federal interest in competition, then the challenged statute or regulation is a valid exercise of state power under the 21st Amendment. There is no further inquiry. See, e.g., *TFWS, Inc. v. Shaeffer*, 242 F.3d 198, 214 (4th Cir. 2001).

Finally, the Supreme Court has held that "[g]iven the special protection afforded to state liquor control policies by the Twenty-First Amendment, they are supported by a ***strong presumption of validity*** and should not be set aside lightly." *North Dakota v. United States*, 495 U.S. 423, 433 (1990) (emphasis added). Although the defendants have raised the 21st Amendment as an affirmative defense, the constitutionally mandated "strong presumption of validity" would be rendered meaningless if the defendants have the burden of proof on this

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point. Accordingly, while the defendants have the burden of going forward and making out a *prima facie* case, Costco must ultimately bear the burden of proof if it is to succeed in its challenge to the validity of state liquor control policy under the 21st Amendment. Moreover, to meet its burden Costco must establish by clear and convincing evidence that the regulatory system fails to further legitimate 21st Amendment interests of the State. Any lesser burden would render the "strong presumption" recognized by the Supreme Court a nullity.

Applying this test to the evidence to be offered at trial, it is clear that the challenged statutes and regulations are a valid exercise of State power under the 21st Amendment.

B. The State's Expressed Interests Are Coextensive With The Core Concerns Of The 21st Amendment.

The evidence offered at trial will show not only that the State has clear and expressed interests in regulating the distribution and sale of alcoholic beverages but also that those interests relate directly to the core concerns of the 21st Amendment.

1. Promotion of Temperance.

One of the greatest concerns of both the Washington Legislature and the Liquor Control Board since the repeal of Prohibition in 1933 has been how best to moderate and control the consumption of alcoholic beverages. The term "temperance" is merely shorthand for this central concept, which requires balancing the notion of reasonable access to alcoholic beverages at reasonable prices with controlling or moderating their availability and use.

As the evidence at trial will show, throughout our nation's history the question of alcoholic beverage regulation has posed challenges for government at both the federal and the state levels. In the years leading up to 1920, the problems the nation had experienced with liquor sales, distribution, and use became the catalyst for Prohibition. The nation ultimately

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decided that Prohibition was a failure: the difficulty of enforcing the ban on liquor sales coupled with the loss of tax revenue during a time both federal and state governments sorely needed funds for the public good ultimately led to Prohibition's demise.

As the nation moved from Prohibition into the uncharted terrain beyond, state legislators - under the power reserved to them by the 21st Amendment - were given the task of creating a comprehensive regulatory system where none had existed only months before. Not surprisingly, one of the principal goals of Washington's alcoholic beverage statutes and regulations was to encourage temperance through a system that balanced reasonable access and reasonable prices against control.

The evidence at trial will show that this interest in temperance was a goal of Washington's Legislature and the LCB in 1933 and has remained a goal of both the Legislature and the LCB since. The statutory enactments themselves establish this. And, as defense expert Professor William Rorabaugh will testify, this is clear from the legislative history of Washington's Steele Act and the annual reports of the Liquor Control Board from the 1930s, which chronicle in unusual detail the LCB's efforts to achieve a controlled yet balanced system. The testimony of the State's witnesses will likewise make clear that this goal today remains a guiding principle of the LCB.

2. Generation and Efficient Collection of Tax Revenue.

Both the expert and lay testimony at trial will show that a second unquestioned goal of Washington's Steele Act and regulations in 1933 and of the challenged statutes and regulations today is the generation of tax revenue and the facilitation of efficient tax collection to protect the revenue stream. This interest was made express by the Washington

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legislature in the debates preceding the passage of the Steele Act and discussed in the contemporaneous reports of the Liquor Control Board. The State's witnesses will likewise testify that revenue generation as well as economy and certainty of tax collection are key concerns underlying today's statutes and regulations, which are in most regards identical to those adopted in 1933.

3. Ensuring Orderly Market Conditions.

One of the key purposes of Washington's Legislature and the LCB in devising a system regulating alcoholic beverages was to create a structure that would balance reasonable access to alcoholic beverages and revenue generation with temperance and control. In other words, Washington State exercised its 21st Amendment power to structure a liquor distribution system that facilitated orderly market conditions. Creating and maintaining such a system meant that the State had to exert and exercise control not only over the structure of that system itself but also over the participants in that system and the way they interacted with one another. This is accomplished in part by reducing competition that would normally guide the market for products other than alcohol. Only by either directly controlling or closely regulating all aspects of the market for alcoholic beverages could the State ensure that its interests in temperance and revenue generation would be closely served. This desire for and interest in a controlled and ordered market is clear from the Legislature's and LCB's first efforts at regulation. It remains equally clear today, as the evidence at trial will show.

Reducing competition, or leveling the playing field, is key to administering a regulatory system for distribution of beer and wine that facilitates orderly market conditions. This goal is achieved in Washington in part by a distribution system that bans price

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discrimination through the requirement of uniform pricing to all distributors and to all retailers and which protects the uniform pricing goal by banning quantity discounts, banning credit and requiring prices to be posted. This encourages stable relationships between producers and wholesalers and between wholesalers and retailers.

Without the controls that stabilize those relationships the number of competitors at all three levels would decrease, and the result would be to consolidate distribution and sales of beer and wine with substantially fewer market participants. In that instance those with the means to negotiate lower prices from the producer and distributor tier, such as Costco, would likely drop their prices, while retailers without such means would raise their prices.

This would defeat the State's avowed interest in a uniform playing field, particularly at the retail level where the detrimental impacts to the health and welfare of Washington citizens from cheaper alcohol available from fewer centralized locations would be felt most directly. That interest is not intended simply to further the interests of one subset of retailers to the detriment of others. Rather, the State's effort to allow smaller retailers to compete is yet another way it attempts to advance its interests in temperance, generation of revenue, and orderly market conditions.

Expert and lay witnesses will explain that the presence of more retailers helps the State both promote temperance and ensure orderly market conditions by, among other things, assuring reasonable local access to alcoholic beverages, alleviating the need for consumers to travel longer distances to big box retailers such as Costco whose business model is to sell many products - including alcoholic beverages - in large volumes. Just as importantly, solvent and responsible small retailers are far more likely to value their liquor licenses and

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refrain from sales outside the system to minors or visibly inebriated consumers. Solvent and responsible small retailers likewise help generate tax revenue, as each small retailer pays sales taxes on alcoholic beverages sold and, so long as he or she is solvent and profitable, is less likely to shirk his or her tax responsibilities.

In contrast, insolvent or marginally profitable retailers will feel great economic pressure to maximize cash flow by making illegal sales and avoiding or deferring the payment of taxes. This would jeopardize the State's interest in temperance as well as its interest in tax collection. Without viable retailers, demand in areas inadequately served by licensed retailers would be filled by illicit "distribution" of beer and wine, again threatening both temperance and tax collection.

C. The State's Regulatory System Furthers The State's Expressed Interests.

As the Supreme Court teaches, the second question this Court must answer is whether the State's regulatory system, considered as a whole or as to its separate parts, has the effect of furthering the interests expressed by the State. It is ironic that in the antitrust phase of this case Costco argued strenuously that the Court should consider the system as a whole while it now argues just as strenuously that the Court should consider each element of the system separately. The evidence at trial will show, however, that either way the Court looks at the system, it and its constituent parts effectively serve the State's 21st Amendment interests.

1. The State's regulatory system, considered as a whole, serves to further the State's expressed 21st Amendment interests.

The evidence will show the State's regulatory system, when taken as a whole, furthers the State's interest in each of the 21st Amendment's core concerns. The system effectively serves the State's interest in temperance and moderate consumption. Costco complains that

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the system raises prices to retailers, resulting in unfair competition. Although the defendants do not concede the system unfairly affects competition, they agree it raises the ultimate price consumers must pay for alcoholic beverages. In fact, the system was designed to do just that. Moreover, as Costco's own expert is expected to testify, the system tends to stabilize prices, which is an important element of the orderly marketing the State strives for.

The expert and lay testimony at trial will show that these increased prices result in reduced demand, helping moderate consumption in general and abusive consumption in particular. Likewise, the system discourages long trips to high-volume on-premise retailers or big-box retailers who sell alcoholic beverages in bulk. It also minimizes the likelihood that retailers will be impelled by drastic price competition to resort to transactions outside the system, such as sales to minors and plainly inebriated consumers. These effects further the State's interest in temperance.

The system as a whole likewise effectively serves the State's interest in generating revenue. Increasing the prices of beer and wine results in reduced consumption of them. However, the reduction in consumption may not be exactly coextensive with the increase in price. To the extent consumption goes down more than prices go up, temperance is served; to the extent consumption goes down less than prices go up, revenues from sales taxes paid at the retail level go up. By ensuring that all retailers, regardless of size, are able to compete in beer and wine sales it increases both the tax revenue generated by smaller retailers and the likelihood that a retailer will meet its tax obligations rather than use funds properly payable as taxes to stave off financial insolvency. By centralizing excise tax collection in the distributor tier the system adds efficiency and economy to the tax collection system.

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The system also directly serves the State's interest in maintaining orderly market conditions. The overarching principle behind the State's system is balance, an equilibrium between reasonable access to beer and wine at reasonable prices and control of their sale and use. To maintain this balance, the State has exercised the discretion conferred on it by the Constitution to construct a three-tier system, one in which the distributor insulates the producer from the retailer and *vice versa*, one that imposes controls regarding pricing, credit terms, discounts, and other limitations so that the market operates in a predictable, transparent, and easily monitored manner.

2. The elements of the State's regulatory system, when considered separately, effectively serve the State's 21st Amendment interests.

Just as the State's system as a whole effectively serves its 21st Amendment interests, the evidence will illustrate that each element of the system, when considered individually, effectively furthers those interests.

As an example, both expert and lay testimony will show that the prohibitions against volume discounts, price discrimination and extending credit to retailers, and the delivered pricing requirement, directly and effectively serve all of the State's valid 21st Amendment interests: temperance, generating and efficiently collecting revenue, and facilitating orderly market conditions. As the State well knows and as economic theory bears out, volume discounts coupled with credit sales will encourage retailers to purchase beer and wine in greater quantities than they otherwise would. This will create incentives for those retailers to market beer and wine more aggressively, leading to increased consumer purchases and consumption. By banning volume discounts and credit sales, the State removes the temptation for retailers to over-purchase, over-market, and over-sell.

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Likewise, the expert and lay testimony will show that if the State allowed volume discounts and credit sales there is little doubt mega-retailers, including Costco, would be able to leverage their market share with producers, allowing them to demand and receive far more favorable purchase terms than other retailers. This would destabilize the retail market, and jeopardize the financial viability of many small or medium-sized retailers. Small retailers struggling to survive against the Costcos and Wal-Marts of the world would be subjected to undue pressure to generate sales, including sales outside the system. Just as troublesome, the struggling retailer would have far greater incentive to shirk its responsibilities to collect and pay taxes.

Similarly, the ban on credit sales discourages marginal retailers from entering the market: one effect of the credit ban is to make it more likely that a retailer will have sufficient capital to operate his or her business and to prevent the retailer from becoming financially over-extended in its dealings with distributors. A retailer with credit problems is more inclined to violate other liquor regulations by selling to minors, violate hours restrictions, or unlawfully promote intoxicating liquor as well as avoid tax responsibilities.

Moreover, the ban on volume discounts and credit terms address the State's long-standing concern over the vertical integration that would result - and had in fact resulted by the early 20th century - without an insulating tier between producer and retailer. The expert testimony will show that prior to Prohibition, disproportionate influence between brewers and retailers led to increased sales, abusive sales practices, and excessive consumption. Historically, brewers owned saloons "lock, stock, and barrel." Competition among brewers and distillers for market share, coupled with "tied houses," resulted in a proliferation of

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saloons and other retail outlets as each producer was compelled to have its own house as a readily accessible alternative to competitors' houses. These "tied houses" were one of the principal evils that led to Prohibition.

Following the repeal of Prohibition, states like Washington adopted regulatory systems designed to prevent vertical integration and other disproportionate influence - whether that influence was wielded by the producer or, as is now the case with sellers like Costco, by the retailer. By separating the tiers and simultaneously prohibiting volume discounts and credit terms, the State serves its interest in promoting temperance, ensuring orderly markets, and protecting a viable, state-wide retail tier.

Additionally, the evidence will show that without the minimum markup provision product distributors could not sell in normal market conditions (such as beer nearing its pull date) would be sold at drastically reduced prices. This would eliminate what is now a complete loss to distributors who must destroy out-of-date beer and other product that doesn't move. It would also introduce a significant amount of beer and wine to the market at fire sale levels, which would lead to increased consumption, and would destabilize the market. Thus, the evidence will show that the minimum mark-up, rather than guaranteeing a profit to distributors as Costco claims, works to limit the ability of distributors to cut their losses.

Finally, the evidence will show that the post and hold and minimum markup requirements also effectively serve the State's valid 21st Amendment interests in temperance, generating revenue, and facilitating orderly marketing. By making it easier for the State to monitor the prices charged by wholesalers and requiring all distributors to impose at least the minimum mark-up on their products regardless of customer, these requirements not only

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enhance the State's ability to police volume discounts, price discrimination, credit sales, and violations of the delivered pricing rule but also help create a level playing field among retailers, all of which directly and effectively serve the State's 21st Amendment interests.

D. The State's Interests Are Not Outweighed By The Federal Interest In Promoting Competition Under The Sherman Act.

As the evidence at trial will show, the restrictions imposed on competition by Washington's regulatory system are not unreasonable. Instead, the system represents a reasonable and measured way of balancing access to beer and wine at reasonable prices against control of their availability and use. The system effectively strikes that balance; moreover, the evidence will show that the impact on competition is not significant.

The testimony of both the expert and lay witnesses will illustrate that the federal interest in competition does not outweigh the State's valid 21st Amendment interest in promoting temperance. As the defense economists will explain and as this Court has previously ruled in addressing the parties' summary judgment arguments, the effect of the State's regulatory system on competition manifests itself in higher prices. The prices for alcoholic beverages in Washington are higher than they would be without the system. Higher prices result in diminished consumption. As a result, consumption in Washington is lower than it would be without the system. The more severe the system's effect on competition, the more dramatic its effect on price and therefore on consumption. Simply put, in balancing the State and federal interests, the Court must take into account the fact that the more the system restricts competition the more it moderates consumption and furthers temperance.

The evidence will show that, Costco's desire for lower prices notwithstanding, the system's effect on competition is relatively slight, as there is fierce competition within the

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confines of the system. The effect on temperance, on the other hand, is significant. If the Court concludes that the effect on competition is greater than defendants believe it to be then it must find that the effect on consumption is even greater. In other words, the State's system does precisely what it was designed to do: raise prices (and decrease consumption) by restricting competition. Thus, to whatever degree the system affects competition the State's interest in temperance outweighs the federal interest in competition.

The evidence at trial will show that the State's valid 21st Amendment interests in generating revenue and ensuring an orderly market outweigh the federal interest in competition. As explained above, the State's interest in ensuring orderly markets serves more as a means to an end rather than as an end in itself. By ensuring an orderly market, restricting competition and encouraging stable relationships at the wholesale and retail levels, the State secures its interests in temperance and generating revenue. Any effect on competition is far outweighed by these interests, both of which are "core concerns" of the 21st Amendment and both of which are vital to the health, safety, and welfare of the citizens of Washington. The fact that Costco might be able to increase its bottom line if the system did not exist does not in and of itself constitute a predominant federal interest in unrestricted competition.

Finally, the State's system - in addition to having only a relatively small effect on the federal interest in competition[5] - directly serves other federal interests. It is entirely consistent with the federal interest in prohibiting price discrimination and controlling the extension of

[5] The system restrains competition, but the effects on competition being weighed against the 21st Amendment concerns in this case to not compare to such egregious antitrust violations as resale price maintenance, found in *Midcal, Schwegmann* and *321 Liquor*, or outright collusion found by the trial court in *Miller v. Hedlund*, 717 F. Supp. 711, 713 (D. Ore. 1989).

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credit as embodied in §§ 2(a) and 2(c) of the Robinson-Patman Act. As the Supreme Court has noted:

> [Section 2(a)] was born of a desire by Congress to curb the use by financially powerful corporations of localized price-cutting tactics which had gravely impaired the competitive position of other sellers. It is, of course, quite true - and too well known to require extensive exposition - that the 1936 Robinson-Patman amendments to the Clayton Act were motivated principally by congressional concern over the impact upon secondary line competition of the burgeoning of mammoth purchasers, notably chain stores.

Federal Trade Commission v. Anheuser-Busch, Inc., 363 U.S. 536, 543-544 (1960) (holding that where beer producer reduced prices in its beer in St. Louis marketing area but maintained higher prices to all purchasers outside of St. Louis area, reduction in price constituted a violation of the Act). The State's system is also entirely consistent with the policies of the National Institutes of Health, which the evidence will show have designated alcohol as a dangerous drug whose consumption should be significantly curtailed.

E. There Is No Requirement Under The 21st Amendment That The Purpose Of Each Element Of The State's System Be Expressed By The Legislature Or By The Liquor Control Board Under A Grant Of Authority From The Legislature.

Costco will argue that the Court should invalidate the State's regulatory system unless the evidence shows either the Legislature or the LCB, acting under a grant of authority from the Legislature, separately and expressly stated a purpose for each element of the system. There is no such requirement in the law. Rather, the Supreme Court's cases imply precisely the opposite. *See, e.g., Granholm v. Heald*, 125 S. Ct. 1885, 1905-07 (2005); *North Dakota*, 495 U.S. at 432; *Bacchus*, 468 U.S. at 276; *Capital Cities Cable*, 467 U.S. at 715. The Supreme Court has never held that there must be a clear identification in the statue of each core concern intended to be served by each statutory provision.

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Contrary to what Costco now asserts, the Fourth Circuit in *TFWS* held that a state need only have expressed an interest that is coextensive with at least one of the core concerns of the 21st Amendment. *See TFWS*, 243 F.3d at 213 (finding adequate for 21st Amendment purposes the fact that the challenged regulatory system had as its avowed goal the promotion of temperance). A sufficient expression of intent may appear in many places and in many fashions: in the context of litigation, in legislative history or administrative materials, or simply in the fact that the Legislature has enacted legislation and the LCB has adopted regulations the natural consequences of which are to promote temperance, generate revenue, and ensure orderly and stable market conditions.

Costco is wrong that the law requires either the Legislature, or the LCB acting under a grant of authority from the Legislature, to express the purpose of each element of the system. The evidence at trial will show that the State has more than adequately expressed its valid 21st Amendment interests.

F. There Is No Basis In Law For Costco's Theory That The State Must Show It Could Further Its 21st Amendment Interests Through Other Reasonable Alternatives.

Costco will also argue that the Court should invalidate the State's regulatory scheme if it finds there are other reasonable and less burdensome alternatives the State might have chosen. By making that argument, Costco attempts to conflate the standard governing a court's inquiry in a dormant commerce clause challenge with the standard governing the inquiry into a 21st Amendment defense. Under the dormant commerce clause - a matter that is not at issue in this trial - the Court may ask whether a statute or regulation "'advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory

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alternatives'" *Granholm*, 125 S. Ct. at 1905 (citation omitted). That, however, is not part of the 21st Amendment inquiry, which asks only whether the State's expressed interest relates to and has the effect of furthering a core concern of the 21st Amendment and outweighs the federal interest in competition. The Court should decline Costco's invitation to import a new element into the 21st Amendment analysis.

G. Costco's "Capture" Theory Has No Place In The Court's Analysis Of Twenty-First Amendment Issues.

Defendants anticipate Costco will argue, as it has elsewhere, that the Court should invalidate the challenged statutes and regulations because they were enacted by a "captured" Legislature and Liquor Control Board. Costco has already acknowledged that there is no legal authority for applying this theory here. However, a number of the exhibits Costco has offered leave defendants with no choice but to assume Costco will advance the argument again.

There is no basis in law for finding a statute or regulation invalid simply because the enacting body responded to lobbying by an interested stakeholder. In making its "capture" argument Costco asks the Court to create new law, directly importing a generally-disregarded Sherman Act theory into the realm of the 21st Amendment.

1. No case has ever applied the concept of "capture" in assessing a 21st Amendment defense.

Although Costco has long complained that "the industry" has "captured" the LCB, none of the cases interpreting the 21st Amendment have found that the notion of "capture" has anything to do with the 21st Amendment. Instead, the relevant questions are whether the State's expressed interest is closely related to a core 21st Amendment concern and if so, whether the challenged statute or regulation furthers an expressed State interest that

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outweighs the federal interest in competition. The notion of "capture" has no relevance to the 21st Amendment.

2. Even the cases that acknowledge the "capture" theory in other contexts have declined to apply it.

While the "capture" theory has been mentioned in other contexts, the courts do not apply it, recognizing it has little place in contemporary jurisprudence.

For example, courts assessing antitrust challenges to statutes and regulations consistently disregard the "capture" theory. *See Zimomra v. Alamo Rent-A-Car, Inc.*, 111 F.3d 1495, 1506 (10th Cir. 1997) (Henry, J., concurring); *Wood v. General Motors Corp.*, 865 F.2d 395 (1st Cir. 1988); *Sessions Tank Liners, Inc. v. Joor Manufacturing, Inc.*, 827 F.2d 458 (9th Cir. 1987), *vacated by Joor Manufacturing, Inc. v. Sessions Tank Liners, Inc.*, 487 U.S. 1213 (1988); *City Communications, Inc. v. City of Detroit*, 660 F. Supp. 932, 935 n. 2 (E.D. Mich. 1987).

The Supreme Court has recognized that a government responsive to private interests or lobbying nevertheless acts for the public good and that the statutes and regulations enacted by that government will not fall simply because they were procured by interested parties:

> Few governmental actions are immune from the charge that they are "not in the public interest" or in some sense "corrupt." The California marketing scheme in *Parker [v. Brown]* itself, for example, can readily be viewed as the result of a "conspiracy" to put the "private" interest of the State's raisin growers above the "public" interest of the State's consumers. The fact is that virtually all regulation benefits some segments of society and harms others; and that it is not universally considered contrary to the public good if the net economic loss to the losers exceeds the net economic gain to the winners. *Parker* [*v. Brown*] was not written in ignorance of the reality that determination of "the public interest" in the manifold areas of government regulation entails not merely economic and mathematical analysis but value judgment, and it was not meant to shift that judgment from elected officials to judges and juries.

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Columbia v. Omni Outdoor Advertising, Inc., 499 U.S 365, 377 (1991) (rejecting a "conspiracy exception" to the state action doctrine).

3. To the extent Costco relies on *Fisher v. City of Berkeley* to support its "capture" theory, its reliance is misplaced.

Costco first raised its "capture" theory during the parties' cross-motions for summary judgment. There, relying on *Fisher v. City of Berkeley*, 475 U.S. 260 (1986), Costco argued the Sherman Act preempted the State's regulatory system because "the *originator* of the restraints" was private, regulated industry instead of "a governmental body furthering public policy objectives." *See* Costco's Motion for Summary Judgment on First Claim at 5:44-48. To the extent, however, Costco claims the Supreme Court in *Fisher* "distinguished between a 'restraint imposed unilaterally by government' and one that is of private impetus concealed under a 'gauzy cloak of state involvement,'" it misrepresents the holding of that case. *See* Motion on First Claim at 7:31-35 (citations omitted).

The *Fisher* Court never once looked behind the challenged ordinance to the manner in which it was enacted. Instead, it made clear at the outset that the motivation behind the ordinance was not before it:

> We begin by noting that appellants make no claim under either § 4 or § 16 of the Clayton Act, 15 U.S.C. §§ 15 and 26, that the process by which the Rent Stabilization Ordinance was passed renders the Ordinance the product of an illegal "contract, combination..., or conspiracy." *Appellants instead claim that, regardless of the manner of its enactment, the regulatory scheme established by the Ordinance, on its face, conflicts with the Sherman Act and therefore is preempted.*

Fisher, 475 U.S. at 264 (emphasis added). The *Fisher* Court did nothing more than analyze a facial challenge to a rent control ordinance, never looking behind the face of the ordinance.

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4. Costco's "capture" theory strikes at the heart of a party's right to participate in the political process as recognized by the *Noerr-Pennington* doctrine.

Although the *Noerr-Pennington* doctrine is an antitrust defense and not at issue in this trial, the policy concerns underlying the doctrine show why the Court should decline Costco's invitation to apply the "capture" theory to the 21st Amendment. First articulated in *Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961), the *Noerr-Pennington* doctrine makes clear that the Sherman Act does not penalize lobbying activities. Costco's "capture" theory runs directly counter to the basic tenet of democracy, articulated in the *Noerr-Pennington* doctrine, that individuals and entities have the right to lobby the government and that the government, in turn, can respond by enacting measures helpful to some but harmful to others. Try as it might to discount that core notion of representative democracy, Costco cannot raise the "capture" theory as a bar to legitimate political activity and legitimate governmental responses.

H. The Ban On Retailer-To-Retailer Sales Is Not An Improper Restraint Of Trade

Costco argues that the ban on retailer to retailer sales imposed by RCW 66.28.070 and WAC 314-13-010 is pre-empted by the Sherman Act because it is a "customer allocation" restraint, and thus is a horizontal *per se* restraint on trade. Costco paints with too broad a brush. Costco attempts to establish that the retailer-to-retailer sales ban is the same as a private agreement between the wholesalers not to compete with one another for customers. Costco's Supplemental Brief at 8. But Costco's argument ignores the fact that the retailer-to-retailer sales ban is a legitimate part of the State's liquor regulatory system. The ban is designed to control the amount of market power available to actors at each level of the three tier system and to control the number of sources from which the type of high volume sales

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associated with sales to retailers can be made. Under *Granholm v. Heald*, the State's three-tier system is "unquestionably legitimate." *Granholm*, 125 S. Ct. at 1905 (citations omitted).

In the case law relied upon by Costco, private actors with significant market power engage in criminal violations of the Sherman Act when they explicitly agree to restrict their sales to a particular geographic area or agree to refrain from contacting or doing business with one another's customers. *United States v. Topco Associates, Inc.*, 405 U.S. 596, 612 (1972) (licensing agreement prohibited retailers from selling to any customers outside geographic area and retailers could sell to other retailers under a specific license to do so); *United States v. Brown*, 936 F.2d 1042 (9th Cir. 1991) (agreement between state's two largest billboard companies not to compete for billboard sites); *Palmer v BRG of Ga., Inc.*, 498 U.S. 46 (1990) (agreement between two bar review companies not to compete in each other's territories and to share profits resulted in an immediate increase in price from $150 to $400); (*United States v. Suntar Roofing, Inc.*, 897 F.2d 469 (10th Cir. 1990) (agreement to allocate roofing customers); *State v. Goodman*, 850 F.2d 1473, 1476 (11th Cir. 1988) (agreement among garbage collection companies not to compete for bids); *United States v. Coop. Theatres of Ohio, Inc.*, 845 F.2d 1367 (6th Cir. 1988) (agreement not to contact each other's customers).

Costco argues that "with retailer customers allocated entirely to wholesalers ...wholesalers can charge higher prices." Costco's Supplemental Brief at 9. And indeed, "[u]nder the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal *per se." Palmer, 498 U.S. at 48; see also Catalano, Inc.* v. *Target Sales, Inc.*, 446 U.S. 643, 64 L. Ed. 2d 580, 100 S. Ct. 1925 (1980) *(per curiam).*

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But here the ban on retailer-to-retailer sales is not intended to affect price but to prevent the abuses that historically resulted in one level of the market gaining too much control over another. At the same time that the ban prevents retailers from selling to other retailers, it also restricts wholesalers from selling directly to consumers. Instead of a simple agreement between parties to allocate market share and ultimately drive prices up and increase profit, the retailer-to-retailer ban should be considered in context as part of the state's regulatory system that controls the type of distribution at each level of the beer and wine market.

Even assuming the retailer-to-retailer sales ban is an anticompetitive restraint, it is not a *per se* violation of the Sherman Act. *C.f. Bogan v. Hogkins*, 166 F.3d 509, 513 (2nd Cir. 1999). Restraints that involve combinations of persons at different levels are not ordinarily considered "*per se* violations." *United States v. Topco Associates, Inc.*, 405 U.S. 596, 608 (1972); *see also Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46, 49 (1990). When a plaintiff challenges a vertical allocation, the court is to apply a rule of reason analysis, "the standard traditionally applied for a majority of anticompetitive practices challenged under § 1 of the Act." *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 59 (1977). The rule of reason analysis precludes summary judgment because it requires the court to engage in detailed fact-finding in order to determine reasonableness of the restraint based on the "facts peculiar to the business, the history of the restraint, and the reasons why it was imposed." *Brown*, 936 F.2d at 1045.

Costco urges the Court to condemn the retailer-to-retailer sales ban under the "quick look" approach. However, that approach is applicable only in analysis of activity that is not

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per se violative of the Sherman Act. Thus, by making the argument Costco impliedly acknowledges that this restraint is not a per se violation. That being the case, it is not subject to preemption by the Sherman Act.

Finally, it should be noted that Costco's assault on the retailer-to-retailer sales ban is a frontal assault on the entire licensing system. If it were illegal "customer allocation" for retailers to obey the law and sell only to consumers it would be equally illegal for retailers to refrain from selling to unlicensed retailers. There is no principled way to distinguish between the two scenarios using Costco's analysis.

Even if the ban on retailer-to-retailer sales is preempted by the Sherman Act, however, it is a legitimate and effective part of Washington's regulatory system and should be upheld under the 21st Amendment. As noted above, the ban on retail-to-retail sales is integral to the state's goal of regulating the relationships between producer, distributor and retailer through the three-tier system, thereby facilitating orderly marketing.

I. General Categories Of Evidentiary Objections

The defendants do not argue either the authenticity or admissibility of the majority of the documentary evidence Costco offers as exhibits. However, there are several broad categories of proposed exhibits to which the defendants object. Generally speaking, the objections are on two grounds, because the evidence is irrelevant to the inquiry before the court and inadmissible under FRE 402 or because the evidence ought to be excluded under FRE 403. This discussion is intended to alert the Court to the general categories and general subject of the objectionable documents, and does not discuss with specificity the proposed

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exhibits falling into the particular categories. For the Court's convenience, the exhibit numbers at issue will be set out in footnotes. [6]

1. The legislative intent and the LCB's intent are clearly expressed in statute and rule and evidence consisting of extrinsic material surrounding enactment is irrelevant and inadmissible.

As discussed above, the issue before the Court is whether Washington's three-tiered regulatory system governing the distribution and sale of beer and wine is valid under the 21st Amendment. Costco believes that the system is invalid because members of the regulated community actively participated in the legislative and rulemaking processes related to the evolution of the challenged statutes and rules from their original enactment in 1934 to the form in which they are before the Court today. As discussed above there is no legal support for Costco's assertion that the "capture theory" applies to 21st Amendment jurisprudence. Nonetheless, a large number of Costco's proposed exhibits appear to be offered solely for the purpose of supporting and advancing that untenable theory.

Specifically, Costco offers exhibit after exhibit of newsletters, action alerts, meeting minutes and e-mails from WBWWA's executive director advising the WBWWA membership of potential legislative action and urging the membership to contact elected officials. Other materials include WBWWA's directives to its lobbyists, its legal counsel and its executive director to set up meetings with legislative leadership and with LCB Board and staff to communicate the organization's positions and concerns. Also offered as evidence are materials showing that WBWWA's lobbyist, lawyer, executive director or Board or Directors did just as directed and contacted LCB or the legislature in an attempt to influence the process

[6] LCB and WBWWA also reserve the right to make additional objections not outlined here, such as to the hearsay nature of specific material and additional relevance objections as is appropriate when documents are

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to generate a result beneficial to the organization. Sometimes the WBWWA was successful in securing its legislative agenda, sometimes it was not. Sometimes the LCB agreed with WBWWA's stated position, sometimes it did not. When the WBWWA was successful, it often alerted its members and the press.[7]

None of the advocacy efforts detailed in the documents proposed to be admitted into evidence are illegal or improper. More to the point, none of those efforts, and none of the documents purporting to detail them, are relevant to the question of whether the regulatory system, as it presently exists, is a valid exercise of the powers granted to the state of Washington under the 21st Amendment to structure the beer and wine distribution system.

The legislature's intent with respect to its laws, and LCB's corresponding rules and enforcement efforts, relating to beer and wine distribution and sales is stated clearly in RCW 66.28.180:

> This section is enacted, pursuant to the authority of this state under the twenty-first amendment to the United States Constitution, to promote the public's interest in fostering the orderly and responsible distribution of malt beverages and wine towards the effective control of consumption; to promote the fair and efficient three-tier system of distribution of such beverages; and to confirm existing board rules as the clear expression of state policy to regulate the manner of selling and pricing wine and malt beverages by licensed suppliers.

When a statute is plain and unambiguous on its face, courts do not look either to legislative history or extrinsic materials to interpret the language. *E.g., Church of Scientology of California v. U.S. Dep't of Justice*, 612 F.2d 417, 421 (9th Cir.1979).

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offered during the course of the trial.

[7] *See, e.g.*, Proposed Trial Exhibit Nos. 84, 85, 94, 97, 98, 101, 103, 104, 107, 1115, 118, 119, 122, 125, 126, 128, 133, 134, 149, 150, 153, 158, 162, 163, 165, 167, 169, 170, 173, 176.

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Whether Costco agrees with the legislative policy or not; regardless of who advocated for or drafted this language, any other portion of the statutory three-tier system, or the rules construing it; and regardless of what desire or goal may have motivated the drafter or those who encouraged enactment, the enactments and adoptions are valid. Determination of the validity of Washington's system under the 21st Amendment does not require consideration of historical materials created by advocates. Even if the materials Costco offers are deemed relevant under FRE 401 and admissible under FRE 402 they are misleading, confuse the issues legitimately before the Court and should be excluded from evidence under FRE 403.

2. Evidence of other states' alcohol regulatory systems is irrelevant and inadmissible.

The issue before the Court is whether the manner in which Washington exercises authority over beer and wine distribution directly relates to and serves to advance the State's interests under the 21st Amendment. Costco offers evidence of regulations from other states, presumably to show that Washington's chosen system is invalid because it could advance its interests in a different way.[8] How other jurisdictions assert their authority under the 21st Amendment is irrelevant under FRE 401 and the evidence is inadmissible under FRE 402.

3. Evidence relating to the distribution and sale of spirits by the LCB is irrelevant and inadmissible.

Costco has challenged the three-tier distribution system for beer and wine. Evidence of what the state does or does not do with respect to purchasing, pricing and selling spirits is irrelevant under FRE 401 and inadmissible under FRE 402.[9]

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[8] *See* Proposed Trial Exhibit Nos. 31, 86 and 186.

[9] *See* Proposed Trial Exhibit Nos. 5, 242.

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4. Evidence relating to analysis by Paul Cramton of posted prices under a prior version of RCW 66.28.180 is irrelevant and inadmissible.

Costco offers hundreds of pages of documents consisting of materials and analysis created by Paul Cramton.[10] Mr. Cramton viewed the prices posted with the LCB by beer and wine manufacturers and wholesalers, and compiled the data into "reports" which he then offered to interested persons for a subscription fee. Effective March 31, 2004 RCW 66.28.180 shielded posted prices from disclosure until the prices became effective, meaning neither Mr. Cramton nor anyone else can see what prices have been posted in advance of the effective date of the prices.

What prices were between 1994 and 2003 when Mr. Cramton offered his services and what, if anything, competitors did with the information Mr. Cramton compiled is of no consequence to the validity of the current regulatory system under the 21st Amendment. The Cramton reports as a category are irrelevant under FRE 401 and inadmissible under ER 402. Even if Costco could conjure up some claim of relevance for conduct occurring under a law that no longer is in effect, any probative value of the evidence is outweighed by the danger of confusion of the issues as well as by considerations of undue delay, waste of time or needless presentation of cumulative evidence. FRE 403.

5. Evidence related to the now resolved commerce clause challenge to the ban on direct shipments to Washington retailers from out-of-state producers is irrelevant and inadmissible.

This Court considered and ruled on Costco's assertion that Washington law violated the United States Constitution with unequal treatment of in-state and out-of-state producers. The issue is no longer before the Court. Thus the evidence Costco offers on the issue of direct

[10] Proposed Trial Exhibits 109, 254-268, 270-297.

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shipments to either consumers or retailers is irrelevant and inadmissible. The evidence consists of legal briefing offered in this case and in the *Granholm* case and of various other documents discussing direct shipping policies prior to the *Granholm* decision and prior to this Court's commerce clause ruling.[11]

Nothing in those materials is relevant to the issue remaining for trial and should be excluded under FRE 402. Here too, should some relevant purpose be conjured up, the materials should be excluded from evidence under FRE 403 as their admission would result in a confusion of the issues far outweighing any probative value.

6. Evidence of advocacy group communications, positions, statements and functions is irrelevant and inadmissible.

Another category of evidence consists of materials created and disseminated by WBWWA to its members and to others, and materials produced and disseminated by other entities such as the Washington State Medical Association, but which are not related to the challenged three-tier system of wine and beer distribution. Topics include advertising regulations and blood alcohol levels. [12]

What a particular interest group says to another about general alcohol-related issues cannot be probative of whether or not the challenged system of control of beer and wine distribution are immunized under the 21st Amendment. However, objection to this category of evidence should not be construed as objection to evidence of stakeholder groups' attempts to address the LCB on these issues. Where such evidence is offered no objection is stated.

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[11] Proposed Trial Exhibits Nos. 172, 222, 223, 308, 313.

[12] *See* Proposed Trial Exhibit Nos. 88, 89, 90, 91, 92, 169.

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The only objection is to evidence of purely external statements and communications, relating to the challenged restraints or to other alcohol control policies.

7. Any probative value of evidence of distributor agreements is outweighed by its tendency to mislead and confuse the issues and is cumulative of anticipated testimony of distributors.

Costco offers into evidence numerous examples of agreements between beer and wine producers and the wholesalers who will handle those products.[13] State law requires that such agreements be filed with LCB and LCB's receipt of supplier and distributor appointment contracts is part of the overall system of control over beer and wine distribution.[14] Thus, the objection is not to relevance, but to admissibility under FRE 403. Costco asserts that the agreements provide evidence that wholesalers, by contractual agreement, sell and promote beer and wine products. The slight probative value of the evidence is outweighed by the tendency for confusion of the issues and by the danger of the evidence being used in a misleading manner. Moreover, the sheer number of agreements offered into evidence is cumulative of the expected testimony at trial of several distributor witnesses.

8. Any probative value of evidence of promotional materials generated by private retail licensees is outweighed by its tendency to mislead and confuse the issues.

In addition to offering the above-described distributor agreements into evidence Costco offers evidence of "promotions" at the retail level, consisting of private retailers' advertising circulars and of some restaurant licensees' happy hours.[15] Here too, any probative

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[13] Proposed Trial Exhibits 298-304.

[14] Costco does not challenge the requirement that breweries and wineries file with the LCB copies of agreements with distributors of the producer's product. RCW 66.28.180 (3)(a).

[15] Proposed Trial Exhibit Nos. 3-4.

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value of this evidence is outweighed by the potential for confusion of the issues and by the potential for the evidence to mislead. It should be excluded pursuant to FRE 403.

III. CONCLUSION

Costco is displeased with the State's regulatory system because that system conflicts with the way it wants to do business. That displeasure, however, is not enough to render the challenged statutes and regulations invalid. Costco's challenge ignores the fact that alcohol is a dangerous product that is and must be closely regulated. The 21st Amendment vests the principal authority for that regulation in the states. Where, as here, the evidence shows that both the system and its constituent parts are related to and effectively serve the core concerns of the 21st Amendment in a manner that outweighs the federal interest in competition, that system is a legitimate exercise of 21st Amendment powers and is not subject to antitrust challenge. The Court should decline Costco's invitation to act as a super-legislature, and should instead leave intact the system the State has devised under its 21st Amendment powers and the balance that system strikes.

DATED this 15th day of March 2006.

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